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88-396

Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

The question presented on Appeal is whether the Tax Court correctly allowed Colonial American Life Insurance Company an immediate deduction or expense (in the tax year paid) of the amount paid by the company as a "ceding commission" or "initial allowance" in regard to indemnity reinsurance agreements. This pertains to accounting and tax distinctions between indemnity and assumption reinsurance set out in Internal Revenue Code Sections 806, 809, and 817 and Regulations published thereunder. The Tax Court allowed the deduction in Colonial American, 51 TCM 1123, following Beneficial Life Insurance Co., 79 T.C. 627 (1982). The Honorable Court of Appeals reversed the Tax Court holding the amounts must be amortized over the expected life of the contract and further holding that there was no distinction between the two types of reinsurance.

PARTIES IN THE CASE BELOW

The parties to this Appeal are: COLONIAL AMERICAN LIFE INSURANCE COMPANY and the COMMISSIONER OF INTERNAL REVENUE.

This appeal is taken from the U.S. Court of Appeals for the Fifth Circuit.

The Appellee — Petitioner below is Colonial American Life Insurance Company. The Commissioner of Internal Revenue is the Appellant — Respondent below.

Pursuant to Sup. Ct. R. 28.1, it is noted that Fleet Financial Group, Inc. is the parent corporation of petitioner Colonial American Life Insurance Company.

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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY

Appellant

VS.

COMMISSIONER OF INTERNAL REVENUE

Appellee

JURISDICTIONAL STATEMENT AND PETITION

OPINION BELOW

The opinion of the Tax Court is reported at 51 TCM 1123 and the opinion of the Court of Appeals is reported at 843 F. 2d. 201. A copy of the opinion is included in the appendix being filed by the Appellant.

JURISDICTION

The opinion of the United States Circuit Court, Fifth Circuit was entered on April 26, 1988 reversing the Tax Court with orders to enter Judgment consistent with the opinion. Motion for Rehearing was timely filed and was denied by order entered May 25, 1988. Notice of Appeal was filed August 16, 1988 in the United States Court of Appeals for the Fifth Circuit. This Appeal is being docketed with this Court, within the applicable time limits. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 2101 and Rules 10, 11 and 12 of the Supreme Court.

STATUTORY PROVISIONS INVOLVED

The Court of Appeals was concerned with Internal Revenue Code Sections 162, 801(a), 806(a), 809(b), (c) and (d), 817, 818(a) and 820 and Regulations issued thereunder. These are reproduced in the appendix filed herewith.

STATEMENT

Colonial, a Louisiana corporation engaged in the business of writing and reinsuring life, accident and health insurance contracts and qualified for federal income taxation as a life insurance company. In 1975 and 1976 it simultaneously entered into coinsurance and modified coinsurance agreements as reinsurer with respect to life insurance policies written by Transport Life Insurance Company (Transport). Under the 1975 coinsurance agreement, Colonial agreed to reinsure 3 percent of Transport's liabilities on a block of whole life insurance policies in return for 3 percent of future premium income from those policies. The agreement called both for initial consideration (referred to also as a ceding commission) payable by Colonial to Transport in the amount of $60,000, and for a reinsurance premium payable by Transport to Colonial in the amount of $675,762 for assuming a share of Transport's reserve liability with respect to the reinsured policies.

Under the modified coinsurance agreement, Colonial reinsured an additional 31 percent share of the same block of life insurance policies, and agreed to pay Transport an additional ceding commission of $620,000 as consideration for the right to a proportionate additional share of Transport's future income on the policies.

Effective July 1, 1976, Colonial, as reinsurer, simultaneously entered into a second pair of coinsurance and modified coinsurance agreements with Transport respecting the same block of life insurance policies. This pair of agreements followed the same general pattern as the first set. The

coinsurance agreement covered an additional 3.6 percent share of the block of policies. The agreement provided for a ceding commission of $72,000 payable by Colonial to Transport, and for a reinsurance premium of $851,398 payable by Transport to Colonial for assuming Transport's liability for the reserves attributable to this 3.6 percent share of the reinsured policies. Under the modified coinsurance agreement executed at the same time, Colonial acquired an additional 39 percent share of the block of policies, agreeing to pay Transport a ceding commission of $780,000. Once again, no reserves were shifted to taxpayer under this agreement, and, thus, no initial reinsurance premium was called for.

Under the agreements, Transport retained all the records pertaining to the subject block of policies and continued to administer the business. The agreements also provided that Transport would pay Colonial its percentage of the income from the reinsured policies under the four reinsurance agreements and Colonial would then reimburse Transport for that portion of the expenses and benefit payments attributable to Colonial's share of those policies. Additionally, Transport was to have the right to reacquire the business on a scheduled basis.

With respect to both the 1975 and 1976 modified coinsurance agreements, Colonial and Transport consented to the application of the rules for the optional tax treatment of policies reinsured as then provided by Section 820 of the Internal Revenue Code of 1954 and Section 1.820-2 of the Treasury Regulations on Income Tax. As a result of those elections, Transport's retention of the reserves applicable to Colonial's share of the reinsured policies was treated, for federal income tax purposes as being solely custodial in nature for the benefit of Colonial. Consequently, the modified coinsurance transactions were treated in the same manner as the conventional coinsurance transactions on Colonial's income tax returns for these years — i.e., as if Transport had shifted a proportionate

share of the reserves to Colonial under all four agreements and had paid over to taxpayer an amount sufficient to cover such reserves in each instance.

On its corporate income tax returns (Forms 1120L) for 1975 and 1976, Colonial recognized as income, pursuant to Code Section 809(c)(1), the gross amount of consideration received, or deemed received, from Transport for assuming liability for the indemnified policies and deducted pursuant to Section 809(d)(2) the corresponding amounts of the reserve liabilities attributable to its share of the reinsured policies under all four agreements. In addition, Colonial deducted the ceding commissions paid to Transport on these agreements ($680,000 for 1975 and $852,000 for 1976), along with the finder's fee ($13,600) for the 1975 transaction, as "other deductions" pursuant to Section 809(d)(12) of the Code.

The Commissioner disallowed the deductions for the ceding commissions based on the determination that the ceding commissions payable to Transport under those agreements were attributable to the acquisition of intangible assets (*viz*, the right to share in future premium income thereunder) and, thus, that those amounts were neither deductible nor amortizable on the theory that the intangible rights acquired had indeterminate useful lives. Alternatively, the Commissioner determined that, to the extent such intangible rights did have determinable lives, the amounts would be amortized.

Colonial thereupon petitioned the Tax Court for redetermination of the deficiencies, asserting that the Commissioner erred in disallowing the deductions it had claimed with respect to the consideration payable to Transport under the agreements in question.

The Court held, as it has in *Beneficial Life Insurance Co.* v. *Commissioner*, 79 T.C. 627 (1982), that the "gross" consideration flowing to taxpayer under the terms of the agreement (and the amount deemed to constitute such consideration under

the parties' Section 820 election) with respect to the assumption of reserves must be included in gross premiums. The Court held, however, as it also had in *Beneficial Life*, that Colonial is nevertheless entitled to an immediate deduction for such ceding commissions in the case of indemnity reinsurance transactions such as those involved here. The Tax Court recognized that such commissions would have to be amortized over the estimated life of the policies in the case of assumption reinsurance transactions, but, relying on its earlier opinion in *Beneficial Life*, ruled that ceding commissions paid to the reinsured in indemnity reinsurance transactions may be deducted in full in the year of payment as "consideration arising out of reinsurance ceded" under Section 809(c)(1) of the Internal Revenue Code.

The Commissioner appealed to the United States Court of Appeals, Fifth Circuit. The Court of Appeals reversed the Tax Court holding the amounts paid had to be amortized over the useful life of the business and could not be deducted in the year paid. It followed the opinions of the Eighth Circuit in *Modern American Life Insurance Company v. Commissioner*, 830 F. 2d 110 (8 Cir. 1987) and *Prairie States Life Insurance Company v. U.S.*, 828 F. 2d 1222 (8 Cir. 1987).

SUBSTANTIAL QUESTION PRESENTED

The Fifth Circuit, in following the Eighth Circuit is in conflict with the Tenth circuit consideration of the distinctions of assumption reinsurance and indemnity reinsurance. *Security Benefit Life Insurance Co.*, 726 F 2d 1491 (10 Cir 1984), See also conflict with the Sixth Circuit affirmation of the Tax Court in *Buckeye Union Casualty Co.*, 54 T.C. 13 affd 448 F. 2d 228 (6 cir. 1971).

The Court has also failed to apply accounting rules mandated by this Court in *Commissioner. v. Standard Life and Accident. Ins. Co.* 443 US 148 (1977).

The Seventh Circuit has affirmed the Tax Court in an opinion handed down August 11, 1988 in *Merit Life Insurance*

Co. v. Commissioner (No. 87-2129). Merit Life involved the same type of indemnity reinsurance as in Colonial; thus a precise conflict between the Circuits on this issue is created.

The Commissioner's position in this case stems from its failure to recognize the ultimate and basic nature of the reinsurance business. All insurance, whether it be the result of an individual transfer of risks between an individual and an insurance company, or the sharing of risks between two or more insurance companies, involves the purchase of insurance by the insured and the sale of insurance by the insurer. An individual buys insurance in order to transfer the mortality risk to an insurance company (which is in the business of spreading that risk over many individual lives). A consideration is charged for that transfer by the company and is paid by the individual insured. The calculation of that premium or consideration contemplates the collection of monies (premiums) and the ultimate payment of benefits. This contract recognizes a cash stream flowing from the insured to the insurer and ultimately from the insurer back to the insured or his beneficiary. The difference between the present value of the cash stream flowing to the insurance company from the insured (the premium) and the present value of the benefits (the cash stream flowing from the insurer to the insured) plus expenses, represents the present value of expected future profits on that business. The excess of amounts received from the insured over amounts paid to the insured (together with interest earnings) represents ultimately the amounts available for payment of expenses and the realization of profit. The insurer is willing to assume the risks as set out in the individual life insurance policy because it ultimately expects to realize a profit from this long term contract. In order to carry its business the insurer pays expenses made up of taxes, commissions, underwriting costs and administrative overhead, which in the first year exceeds the premium under normal circumstances. In renewal years the insurer must not only pay current expenses but recoup first year or initial costs.

Respondent does not now and has never contended that the amount expended by an insurer in selling an individual policy represents consideration expended for the realization of future profit. Respondent is bound by Sec. 818(a) I.R.C.; *Standard Life and Accident Insurance Company v. Commissioner* 433 U.S. 148 1977.

In reinsurance transactions (with the exception of what is termed assumption re-insurance) the same sale by the *insurer* to the *insured* and transfer of risk from the insured to the insurer takes place. The ceding company (the insured) seeks to buy insurance in order to transfer and spread a risk or risks. The reinsurer (the insurer) sells this service and accepts the transfer of such risks as may be called for under the contract.

This transaction may represent the transfer of risk involving one policy or a number of policies and may involve a transfer on a policy by policy basis or upon a block basis. See *Thompson, Reinsurance* 3d edition, Chapter 6. The types and usage of such contracts is varied, but they all involve the transfer of risk from the ceding company to the reinsurer for a consideration commonly called reinsurance premium or consideration.

An insurance company buys reinsurance for the same reasons that an individual buys insurance: the transfer of risk to be shared by others rather than itself. Reinsurance premiums are calculated in the same manner as individual insurance.

The reinsurer collects premiums, pays expenses, fees and benefits, and intends to have something left over for profit. The premium or consideration charged by the reinsurer is merely its measure of what is necessary in its business judgment to collect from the ceding company for carrying the risk on the policies reinsured through their expected term. This is similar in nature to a single premium charged by the reinsurer, which together with future premiums and investment earnings will ultimately cover the benefits to be paid by the reinsurer to the ceding

company and leave it with a profit. The argument of Commissioner pertaining to present value of future profits, merely involves one of the many factors involved in determining that premium.

The entire structure of sub-chapter L recognized this business fact. Property is defined by Section 817(b)(3) I.R.C. as not including insurance and annuity contracts. For that reason, the buying or selling of ~~insurance~~ contracts does not involve capital gain or loss treatment.

Assumption reinsurance, on the other hand, is treated in the code as a transaction similar to the purchase or sale of a capital asset (except that after 1958, capital gain or loss treatment is denied). Sections 806, 809(d)(7), and 817 recognize and provide special treatment for assumption reinsurance as that term is defined in the code. (Section 817(e)) The Commissioner has promulgated regulations under these statutory provisions which recognize the special treatment of assumption reinsurance and the statutory destinction between assumption reinsurance treaties and indemnity reinsurance treaties.

The Commissioner now attempts to ignore this basic destinction, and to treat all reinsurance the same. The Commissioner would argue that this statutory treatment of indemnity reinsurance creates a distortion and to correct this, would have the Court read out of the statutory language any distinction between assumption and indemnity reinsurance. The statutory language is plain and simple. It treats indemnity reinsurance and assumption reinsurance differently. Congress has spoken, The Commissioner should listen. This has been the decision of the Tax Court in the several cases set out above in which the issue has been presented. The conflict between the Circuit Courts should be resolved.

CONCLUSION

For the reasons presented above, probable jurisdiction should be noted and the Court should set the matter of plenary consideration on briefs and oral argument.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing has been made on Counsel for the Commissioner of Internal Revenue on the 6th day of September, 1988 by mailing 3 copies thereof in an envelope, with postage prepaid, properly addressed as follows:

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COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

No. 87-4492.

United States Court of Appeals,
Fifth Circuit.

April 26, 1988.

Commissioner of Internal Revenue disallowed taxpayer reinsurer's deductions of ceding commissions incurred in particular tax years. The United States Tax Court rejected the Commissioner's disallowance of deductions, and Commissioner appealed. The Court of Appeals, Garza, Circuit Judge, held that amounts paid by reinsurer to initial insurer under contract for indemnity reinsurance for conventional and modified coinsurance, including ceding commissions and finder's fee, had to be depreciated or amortized over useful life of interest acquired, and could not be deducted in year costs were incurred.

Reversed with instructions.

Internal Revenue 3372

Amounts paid by reinsuring company to initial insurer under indemnity reinsurance contracts for conventional coinsurance and modified coinsurance, including ceding commissions and finder's fee, had to be depreciated or amortized over useful life of interest acquired, and could not be deducted in year costs were incurred. 26 U.S. C.A. § 809(c)(1), (d)(2); 26 U.S.C.(1970 Ed.) § 809(d)(12).

Appeal from the Decision of the United States Tax Court.
Before GARZA, REAVLEY and DAVIS, Circuit Judges.
GARZA, Circuit Judge.

I

Colonial American Life Insurance Company is a life insurance company that sells life, accident and health insurance. This action was brought by Colonial after the Commissioner of Internal Revenue disallowed Colonial's deductions of "ceding commissions" incurred in 1975 and 1976.[1] The Tax Court rejected the Commissioner's disallowance of Colonial's deductions, holding that amounts paid by a reinsuring company (Colonial) to an initial insurer (Transport) under a contract for indemnity reinsurance may be deducted in the year incurred and not amortized over the anticipated useful life of the policies. We are reversing the Tax Court.

Before considering the narrow tax question involved in this case, it is necessary to first understand the nature of an indemnity reinsurance contract and its relationship to other forms of reinsurance transactions. Reinsurance is an arrangement whereby an insurance company transfers some or all of the risks it has underwritten to another insurance company.[2] The company purchasing the reinsurance is known as the initial insurer, the reinsured, or the ceding company; the company acquiring the risk is known as the reinsurer or the reinsuring company.

There are basically two types of reinsurance — assumption reinsurance and indemnity reinsurance. In assumption reinsurance, the reinsuring company takes over for the initial insurer and becomes directly liable to the policyholders. The

[1]The Commissioner also sought to disallow a "finder's fee" ($13,600) paid by Colonial to Transport Life Insurance Company in 1975.

[2]An insurance company may want to reinsure its risks for a number of reasons including the diversification of its business, the acquisition of another insurance company indirectly through the acquisition of its business, the avoidance of a concentration of risk in one geographic area or line of business, and relief from the surplus drain that may occur as a result of the heavy expenses and the necessity of establishing reserves connected with newly written policies.

initial insurer is relieved of all liability, including the maintenance of the required reserves. The reinsuring company has the duty of establishing and maintaining the required reserves. In addition, the reinsuring company is entitled to all premiums paid and must pay all future claims and expenses with respect to the policies.

With respect to indemnity reinsurance, two variations are relevant here: conventional coinsurance and modified coinsurance. In an indemnity reinsurance contract the initial insurer and the reinsuring company share the benefits and obligations arising out of the reinsured policy or contract. Furthermore, the initial insurer will transfer to the reinsuring company all or part of its liability on the policies being reinsured. The initial insurer remains directly liable to the policyholders and continues to collect premiums and to pay claims and expenses. The reinsuring company will then reimburse the initial insurer for the claims and expenses attributable to the risks it has reinsured.

Conventional and modified coinsurance significantly differ in their effect on the reserves of the insurance companies involved. Essentially, reserves are liability accounts representing the present value of the company's net liabilities under the policies in force. Life insurance companies are required to maintain reserves in an amount equal to the excess of the present value of future benefits payable under the policies over the present value of future net premiums. Such liability must be backed by cash or other assets of the insurance company. In a conventional transaction, the initial insurer reduces its reserves by the amount attributable to the ceded liability. The reinsuring company will then establish reserves to cover that liability acquired. In a modified coinsurance transaction the initial insurer maintains the required reserves and merely collects and pays over to the reinsurer the investment income derived from the assets supporting the reserves.

In conventional and modified coinsurance two exchanges take place: (1) the initial insurer pays the reinsuring company full consideration for the reserve liability assumed, and (2) the reinsuring company pays the initial insurer a "ceding commission" or an "initial allowance" for the business acquired. Insurance companies typically net these transactions, with only the excess amount changing hands. Thus, the reinsuring company has income equal to the reserve liability actually assumed even though such liability exceeds the consideration actually received. This appeal centers primarily over the proper characterization of ceding commissions for the purposes of the Internal Revenue Code. In this case, the ceding company, Transport entered into both conventional and modified coinsurance agreements with the reinsuring company, Colonial.

Under the conventional agreement, Colonial agreed to reinsure three percent of Transport's liabilities on a block of whole life insurance policies in return for a three percent of future premium income from those policies. The agreement called for an initial consideration (ceding commission) in the amount of $60,000 payable to Transport for the right to receive the future income generated by the reinsured policies, and for an additional consideration (reinsurance premium) in the amount of $675,762[3] payable by Transport to Colonial for assuming a share of Transport's reserve liability with respect to the reinsured policies.

Under the modified agreement, Colonial reinsured an additional 31 percent share of the same block of life insurance policies, and agreed to pay Transport an additional ceding commission of $620,000 as consideration for the right to a proportionate share of Transport's future income of the policies. Unlike the conventional agreement, the modified agreement

[3]This figure was calculated from the conventional agreement which specifically called for payment to taxpayer in an amount equal to the new reserves attributable to the risks reinsured.

did not call for an initial reinsurance premium to cover a proportionate share of the reserves on the reinsured policies since no portion of those reserves was shifted to Colonial under this agreement. After netting the amounts payable to each party, $4,238 (without interest) was paid by Colonial to Transport on December 29, 1985. Colonial also paid a finder's fee of $13,600.

On July 1, 1976, a second pair of conventional and modified coinsurance agreements were made with Transport by Colonial as reinsurer. The conventional agreement covered an additional 3.6 percent share of the block of policies. It provided for a ceding commission of $72,000 payable to Transport by Colonial in return for a proportionate share of the future premium income from the block of policies, and a reinsurance premium of $851,398[4] was paid by Transport to Colonial for assuming Transport's liability for the reserves attributable to the 3.6 percent share of the reinsured policies.

Under the modified agreement, Colonial acquired an additional 39 percent share of the block of policies and agreed to pay consideration of $780,000 as a ceding commission to Transport for the right to a 39 percent of Transport's future premium income. No reserves were shifted to Colonial, therefore no initial reinsurance premium was required. After netting the amounts payable to each party, $602 (without interest) was paid by Colonial to Transport on October 5, 1976.

Transport retained all the records regarding the block of policies and continued to process and pay all claims. Transport was to pay Colonial its percentage of the income from the reinsured policies under the new insurance agreements and Colonial was to then reimburse Transport for that portion of the expenses and benefit payments attributable to Colonial's

[4]This figure was calculated similar to the 1975 conventional agreement in an amount equal to the mean reserves attributable to the risks reinsured.

share of those policies. Transport was also to have the right to regain the business on a scheduled basis.

In both the 1975 and 1976 modified coinsurance agreements, Colonial and Transport consented to the application of the rules for the optional tax treatment of policies reinsured as provided by section 820 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.820-2 of the Treasury Regulations on Income Tax (26 C.F.R.).[5] As a result, Transport's retention of the reserves applicable to taxpayer's share of the reinsured policies was treated for federal income tax purposes as being solely custodial for the benefit of Colonial. Consequently, the modified coinsurance transactions were treated in the same manner as the conventional coinsurance transactions on Colonial's income tax returns for these years.

Colonial on its income tax returns for 1975 and 1976, recognized as income pursuant to Code Section 809(c)(1) the gross amount of consideration received, or deemed received, from Transport for assuming liability for the indemnified policies and deducted the corresponding amounts of reserve liabilities attributable to its share of the reinsured policies under all four agreements pursuant to Section 809(d)(2). Colonial, additionally deducted the ceding commissions paid to Transport in the amounts of $680,000 for 1975 and $852,000 for 1976, along with the finder's fee of $13,600 for the year 1975, as "other deductions" pursuant to section 809(d)(12) of the Code. As a result of these transactions, Colonial reported an immediate tax loss of $693,600 for 1975 and $852,000 for 1976, which reduced its gains from operations by the corresponding amounts.

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[5]There were substantial revisions by Title II, Section 211(a) of the Deficit Reduction Act of 1984, Pub.L. No. 98-369, 98 Stat. 494, 720, but the revisions were not in effect during the years in question. Citations to the Internal Revenue Code and Treasury Regulations are from the versions that were in effect during the years in question.

The Tax Court held, as it also held in *Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627 (1982), that Colonial was entitled to an immediate deduction for such ceding commissions in the case of indemnity insurance transactions such as the ones involved here. The Tax Court did recognize that in the case of assumption reinsurance transactions, that such commissions would have to be amortized over the estimated life of the policies.

II

Colonial, as a life insurance company during the years 1975 and 1976, was taxable under sections 801 through 820 of the Internal Revenue Code. In this case, our primary concern is with the computation of the adjusted premium components of the "gain or loss from operations," under Section 809(c)(1), as affected by the ceding commissions paid by Colonial to Transport.

We have previously attempted to clarify the distinctions between the various forms of coinsurance agreements. A closer examination of the coinsurance agreements in question, reveals the modified coinsurance agreements were not pure. They were a variation in that the parties consented to treatment under Section 820 of the Code, which effectively permitted the parties to treat the modified coinsurance agreements as if they had instead entered into conventional coinsurance agreements. Although Transport retained the assets and maintained the proper reserves, Transport was deemed to have done so in a custodial capacity. Thus, for tax purposes the same shift in reserves (and assets) from Transport to Colonial is deemed to have occurred in the two modified coinsurance transactions as actually occurred in the two conventional coinsurance transactions in question. This is relevant because all four reinsurance transactions are treated as though they were conventional coinsurance transactions.

It is a fundamental rule that an amount expended to acquire an asset or economic interest, benefit or advantage with

an income producing life extending substantially beyond the current taxable year may not be expressed in the year of payment but must be depreciated or amortized over its useful life. *See Commissioner v. Idaho Power Co.*, 418 U.S. 1, 12, 94 S.Ct. 2757, 2764, 41 L.Ed.2d 535 (1974). Therefore, without a clear difference in the statute for treatment of assumption reinsurance contracts and indemnity reinsurance contracts, we must apply a "general" tax rule. We are fortunate to have had the Eighth Circuit recently decide two cases with very similar issues. *See Modern American Life Ins. Co. v. Commissioner*, 830 F.2d 110 (8th Cir.1987) (modified reinsurance agreement), and *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (8th Cir.1987) (conventional reinsurance agreement). In *Modern American*, at 114 the court held:

> Because no statutory basis exists for allowing the ceding commission to be deducted as a current expense, the court resorts to generally recognized tax principles to determine the proper treatment of this payment. These principles dictate that costs incurred in the acquisition of an economic interest with an income-producing life extending substantially beyond the taxable year may not be expensed but must be depreciated or amortized over useful life of the interest acquired.

In *Prairie States* at 1234 the court held,

> [T]axpayer may not reduce its income by treating the ceding commission either as a reduction of income under Section 809(c)(1) for 'consideration arising out of reinsurance ceded,' or as an underwriting expense deductible under Section 809(d)(12). Rather, taxpayer must amortize the commission as the cost of acquiring an income-producing asset with a useful life extending substantially beyond the current taxable year.

We believe both cases were well reasoned. As we previously stated, the Tax Court correctly identified that in the case

of an assumption reinsurance agreement, the ceding commissions would be amortized for the life of the policy. Although our case involves an indemnity reinsurance agreement, this circut has rejected an argument for allowing full deduction of the ceding commissions in an assumption reinsurance agreement with reasoning that is applicable here. *See Southwestern Life Ins. Co. v. United States*, 560 F.2d 627, 640-41, (5th Cir. 1977) *cert. denied*, 435 U.S. 995, 98 S.Ct. 1647, 56 L.Ed.2d 84 (1978).

In *Southwestern Life* at 641 we stated:

> The taxpayer's effort to equate the current deductibility of commissions paid in the life insurance industry to agents who put new policies on the books of the company with the payment of $9,800,000 for the acquisition of some 100,000 outstanding policies is not an apt comparison. Atlantic has already paid commissions to its agents for the acquisition of these same policies and the value of the policies to the taxpayer here in no way represents the cost of putting the business on the books of the company. It represents instead, an estimate of the current value to the taxpayer that is represented by having these policies on its books with the expectation of the continuing premiums to be paid in the future.

III

In conclusion, we do not read the statute to treat assumption reinsurance agreements any different than indemnity reinsurance agreement. Therefore, we are holding as the Eighth Circuit held that these ceding commissions paid, including the finder's fee, must be depreciated or amortized over the useful life of the interest acquired.[6] The Tax Court is REVERSED with orders to enter judgment consistent with this opinion.

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[6]The parties stipulated to a seven year life of the policies to be amortized on a straight line basis.

UNITED STATES TAX COURT

COLONIAL AMERICAN LIFE INSURANCE COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 20384-83
Filed: April 1, 1987

DECISION

Pursuant to the opinion of the Court filed June 4, 1986, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is an overpayment for the taxable year 1975 in the amount of $8,659.00 ($4,659.00 of which was paid on June 15, 1976 and $4,000 of which was paid on March 15, 1976), for which amount a claim for refund could have been filed under the provisions of I.R.C. §§ 6511(c) and 6511(d)(2) on May 5, 1983, the date of the mailing of the notice of deficiency; and

That there is an overpayment for the taxable year 1976 in the amount of $51,653.62, which amount was paid on June 20, 1977, and for which amount a claim for refund could have been filed under the provisions of I.R.C. §§ 6511(c) and 6511(d)(2) on May 5, 1983, the date of the mailing of the notice of deficiency.

(Signed) LAWRENCE A. WRIGHT
Judge

Entered April 1, 1987

T.C. Memo. 1986-226

UNITED STATES TAX COURT

COLONIAL AMERICAN LIFE INSURANCE COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Docket No. 20384-83. Filed June 4, 1986.

Thomas G. Nash, Jr., for the petitioner.

Seymour I. Sherman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, *Judge:* Respondent determined deficiencies of $168,031.01 and $197,481.99 in petitioner's Federal income taxes for 1975 and 1976, respectively. After concessions by the parties, the issue remaining for decision is whether the ceding commission paid by a reinsuring company to an initial insurer under contracts for indemnity reinsurance may be deducted currently by the reinsuring company or must be amortized over the anticipated useful life of the policies reinsured.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. For purposes of clarity, the general principles concerning reinsurance are incorporated in the findings of fact.

Petitioner, Colonial American Life Insurance Company (Colonial), was incorporated in 1924 in the State of Louisiana. Its principal place of business at all relevant times was in New Orleans, Louisiana. Petitioner timely filed Federal income tax returns for the calendar years 1975 and 1976.

At all relevant times petitioner was authorized to and did engage in the insurance business in Louisiana and in numerous other states, writing various forms of life, accident, and health insurance. Petitioner's principal insurance risks during the years in controversy consisted of life contingencies originally written by it or written by other companies and reinsured by petitioner.

Reinsurance is an arrangement whereby an insurance company transfers some or all of the risks it has underwritten to another insurance company.[1] The company purchasing the reinsurance is known as the initial insurer, the reinsured, or the ceding company; the company acquiring the risk is known as the reinsurer or the reinsuring company.

There are basically two types of reinsurance — assumption reinsurance and indemnity reinsurance. In assumption reinsurance, the reinsuring company takes over for the initial insurer and becomes directly liable to the policyholders. The initial insurer is relieved of all liability, including the maintenance of the required reserves. The reinsuring company has the duty of establishing and maintaining the required reserves. In addition, the reinsuring company is entitled to all premiums paid and must pay all future claims and expenses with respect to the policies.

With respect to indemnity reinsurance, two variations are relevant here: conventional coinsurance (hereinafter "coinsurance") and modified coinsurance (hereinafter "modified coinsurance"). In contrast to assumption reinsurance, under coinsurance and modified coinsurance, the initial insurer and the reinsuring company share the benefits and obligations

[1]An insurance company may want to reinsure its risks for a number of reasons including the diversification of its business, the acquisition of another insurance company indirectly through the acquisition of its business, the avoidance of a concentration of risk in one geographic area or line of business, and relief from the surplus drain that may occur as a result of the heavy expenses and the necessity of establishing reserves connected with newly written policies.

arising out of the reinsured policy or contract. The initial insurer transfers to the reinsuring company all or part of its liability on the policies being reinsured, but it remains directly liable to the policyholders and continues to collect premiums and to pay claims and expenses. The reinsuring company must reimburse the initial insurer for the claims and expenses which are paid by the initial insurer and which are attributable to the risks it has reinsured.

Coinsurance and modified coinsurance differ, however, in their effect on the reserves of the insurance companies involved. Essentially, reserves are liability accounts representing the present value of the company's net liabilities under the policies in force. Life insurance companies are required to maintain reserves in an amount equal to the excess of the present value of future benefits payable under the policies over the present value of future net premiums. Such liability must be backed by cash or other assets of the insurance company. In a coinsurance transaction, the initial insurer reduces its reserves attributable to the ceded liability and the reinsuring company must establish reserves to cover the liability acquired. In a modified coinsurance transaction, however, the initial insurer maintains the required reserves and merely collects and pays over to the reinsurer the investment income derived from the assets supporting the reserves. Although the initial insurer does not release the reserves and underlying assets, upon the parties' consent to treatment under section 820,[2] the retention of assets and maintenance of reserves by the initial insurer are treated as custodial on behalf of the reinsuring company. Thus, for Federal tax purposes, in both coinsurance and modified coinsurance transactions, the same shift of reserves from the initial insurer to the reinsuring company takes place.

[2]All section references and reference to the "Code" are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

In coinsurance and modified coinsurance two exchanges take place: (1) the initial insurer pays the reinsuring company full consideration for the reserve liability assumed, and (2) the reinsuring company pays the initial insurer a "ceding commission" or an "initial allowance" for the business acquired. Insurance companies typically net these transactions, with only the excess amount changing hands. Thus, the reinsuring company has income equal to the reserve liability actually assumed even though such liability exceeds the consideration actually received.

In 1975, petitioner entered into two reinsurance transactions, one on a coinsurance basis and the other on a modified coinsurance basis, with respect to policies of life insurance originally written by Transport Life Insurance Company (Transport), with petitioner as the reinsuring company and Transport as the initial insurer or ceding company. Petitioner and Transport consented, with respect to the modified coinsurance transaction, to application of the rules for the optional treatment of policies reinsured therein provided by section 820 and the regulations thereunder.

The coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration or ceding commission in the amount of $60,000, and a payment by Transport to petitioner of an amount equal to the mean reserves attributable to the risks reinsured. The modified coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration in the amount of $620,000. The accounting between the two companies with respect to the foregoing transactions (excluding interest) was as follows:

	Coinsurance	Modified Coinsurance
Reserves Transferred	$ 675,762	$ -0-
Ceding Commission	60,000	620,000
Amount Due Transport	$(615,762)	$620,000

In 1976, petitioner as reinsurer and Transport as ceding company entered simultaneously into two further reinsurance transactions with respect to the same policies, which policies belonged to the same groups or blocks of policies affected by the 1975 reinsurance transactions described above. The 1976 coinsurance agreement provided for the payment of an initial consideration by petitioner to Transport of $72,000, and a payment by Transport to petitioner of an amount equal to the mean reserves attributable to the risks reinsured. The 1976 modified coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration in the amount of approximately $780,000. The accounting between the companies with respect to the foregoing transactions (excluding interest) was as follows:

	Coinsurance	Modified Coinsurance
Reserves Transferred	$ 851,398	$ -0-
Ceding Commission	72,000	780,000
Amount due Transport	$(779,398)	$780,000

During 1975, petitioner paid a "finders fee" of $13,600 with respect to its reinsurance transactions with Transport, and deducted this sum as an expense.

In his statutory notice of deficiency, respondent determined that the excess amounts of the required reserves over the cash received by petitioner[3] were attributable to the acquisition of an

[3]These amounts were determined as follows:

	Coinsurance	Modified Coinsurance	Total
1975			
Reserves required	$675,762	$620,000	
Recd. by Petitioner	615,762	-0-	
Excess	$ 60,000	$620,000	$680,000
1976			
Reserves required	$851,398	$780,000	
Recd. by Petitioner	779,398	-0-	
Excess	$ 72,000	$780,000	$852,000

intangible asset with an indeterminate useful life and were not deductible. Alternatively, respondent determined that such excess amounts were attributable to the cost of acquiring assets and must be amortized over their estimated life. He capitalized such amounts and restored them to petitioner's income, but allowed no amortization because the reasonable estimated life of those assets had not been established. He also included those amounts in the computation of petitioner's assets for the taxable years 1975 and 1976, respectively.

Respondent disallowed the deduction for the $13,600 finders fee paid by petitioner in 1975, and restored that amount as an income item and asset for said year. The basis of respondent's action was his determination that such expense was a part of the cost of the 1975 reinsurance transactions with Transport.

OPINION

The first issue is whether amounts paid by a reinsuring company to an initial insurer under a contract for indemnity reinsurance may be deducted currently or must be amortized over the anticipated useful life of the policies.

This Court addressed this question in *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627 (1982). In *Beneficial*, the taxpayer, a life insurance company, entered one assumption reinsurance transaction and seven indemnity reinsurance transactions. In each transaction, the taxpayer was the reinsuring company and received actual consideration from the initial insurer in an amount less than the reserve liability actually assumed. This Court held that, with respect to both the assumption reinsurance transaction and the indemnity reinsurance transactions, the taxpayer must include in income an amount equal to the reserve liability actually assumed. We further held that, with respect to the assumption reinsurance transaction, to the extent the assumed reserve liability exceeded the actual consideration received, such excess represented the cost of business acquired which is amortizable over the useful

life of that business. *Beneficial Life Insurance Co. v. Commissioner, supra* at 642-643. With respect to the indemnity reinsurance transactions, however, we held that to the extent the reserve liability assumed exceeded the actual consideration received, such excess represented a cost of issuing insurance which directly reduces the amount included in income. *Beneficial Life Insurance Co. v. Commissioner, supra* at 646. The Court stated that the Code itself requires different treatment of assumption reinsurance and indemnity reinsurance transactions with respect to the amounts the reinsuring company pays the initial insurer for the business acquired. The Court found that the Code treats an assumption reinsurance transaction as a sale by the initial insurer to the reinsuring company. Thus, the reinsuring company must amortize the cost of the business acquired over that business's useful life. Sec. 1.817-4(d)(2)(ii)(B), Income Tax Regs. An indemnity reinsurance transaction, however, is not treated as a sale by the initial insurer to the reinsurer, but as the initial insurer's purchase of insurance from the reinsuring company.. Reinsurance income includes the consideration received with respect to assuming another's contract liabilities, less "return premiums, and premiums and other consideration arising out of reinsurance ceded." Sec. 809(c)(1). "Return premiums" is defined in the regulations as follows:

> (ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums.

* * *

Sec. 1.809-4(a)(1)(ii), Income Tax Regs. Thus, we held in *Beneficial* that the amount the reinsuring company returns to the initial insurer as a ceding commission may be deducted from the consideration received by the reinsuring company from the initial insurer. We have reviewed the analysis set forth in *Beneficial* and we find it directly applicable to the instant case. Accordingly, we hold that the amount of the ceding commission paid by petitioner to Transport may be deducted.

Respondent argues generally that the cost to petitioner of its reinsurance transactions constitutes an investment in the nature of a capital expenditure or a deferred expense, which must be amortized over the reasonably anticipated life of each respective transaction. In *Beneficial* we responded to a similar argument and therein distinguished the acquisition of an asset from the sale of insurance. We stated:

> Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit, such is also true when an insurance company issues a single policy to an individual. Yet, the expenses relating to that policy are currently deductible. While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet, the Code treats one as the issuance of insurance and one as acquisition of an asset. That makes all the difference.

Beneficial Life Insurance Co. v. Commissioner, supra at 647-648.

In support of his position that the amounts in question must be amortized respondent relies upon *Southwestern Life Insurance Co. v. United States*, 560 F.2d 627 (5th Cir. 1977), cert. denied 435 U.S. 995 (1978). In that case the taxpayer, in purchasing the stock of another insurer, paid an amount in excess of the value of the assets of the acquired company. The Court of Appeals sustained respondent's denial of a current deduction of that excess and found that the taxpayer should

amortize that amount based on section 1.817-4(d)(2), Income Tax Regs. That section requires the reinsurer in an assumption reinsurance transaction to treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense under section 809(d)(12) and amortize such amount over the reasonably estimated life of the contracts reinsured, irrespective of the taxable year in which such amount was paid to the reinsured. According to respondent, because indemnity reinsurance is, by definition, of limited duration, there is no question but that the reinsuring company in an indemnity reinsurance transaction is entitled to amortize its cost over the useful life of the policies reinsured. He concludes that the above regulation was intended merely to assure equal treatment in assumption reinsurance transactions by clarifying the period of amortization, thereby rebutting anticipated claims that the reinsured policies have an indeterminate life and costs connected with their acquisition are, therefore, not amortizable. Furthermore, respondent contends that the above regulation was intended to establish conclusively the right of the reinsuring company in an assumption reinsurance transaction to amortize its costs, not to authorize by inference the current deduction of the ceding commission in indemnity reinsurance.

We disagree with respondent's initial assertion for the reasons set forth in support of our holding in *Beneficial*. Further, a determination as to whether the purpose of the above regulation is to assure the reinsuring company in an assumption reinsurance transaction of a right to amortization is irrelevant to our determination of the issue in this case because the transactions here in issue are indemnity reinsurance transactions, not assumption reinsurance transactions. Finally, petitioner herein does not assert entitlement to a deduction for the ceding commission paid to the initial insurer based on an inference drawn from the above regulation, but rather on the express language of section 809(c)(1).

Respondent next contends that section 809(c)(1) was misconstrued in *Beneficial*. He first argues that the "premiums

and other consideration arising out of reinsurance ceded" to be subtracted from premium income are those paid by an initial insurer to a reinsuring company and, therefore, serve to reduce the premium income of the initial insurer and not that of the reinsuring company. Respondent compares the language of section 809(d)(7) with the language of section 809(c)(1). Section 809(d)(7) provides for the deduction of "consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts * * *." Respondent asserts that the phrase "consideration arising out of reinsurance ceded" appearing in that section must be construed in the same manner as the identical phrase found in section 809(c)(1). He maintains that section 809(d)(7) provides for a deduction by the initial insurer and concludes that section 809(c)(1) also must provide for a deduction by the initial insurer. Finally, he states that the reduction allowed by section 809(c)(1) is an allowance in the case of reinsurance ceded (indemnity reinsurance, see sec. 1.809-4(a)(1)(iii), Income Tax Regs.) analogous to the deduction allowed under section 809(d)(7) in the case of assumption reinsurance.

We disagree with respondent's reading of section 809(c)(1) for the following reasons. Although we believe respondent is correct in his assertion that section 809(d)(7) provides for a deduction by the initial insurer, we do not read section 809(c)(1) so narrowly. First, although the phrase "other consideration arising out of reinsurance ceded" is found in both section 809(d)(7) and section 809(c)(1), this phrase only specifies the sum being referred to, and does not indicate who would be entitled to the deduction with respect to that sum. To find otherwise would be to read this phrase out of context.

Second, by using the phrase "consideration in respect of assuming liabilities under contracts not issued by the taxpayer," the first clause of section 809(c)(1) refers specifically to a reinsuring company. It would therefore be illogical to construe

the second clause as referring only to an initial insurer. The drafters of this section made clear their intent in the first clause; where no similar restriction is expressed in the second clause, none will be imputed.

Respondent next argues that petitioner cannot rely on the first clause of the second sentence of section 809(c)(1) as authority for its claimed deduction. That sentence states: "*Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded,* amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums." (Emphasis added.) For support, respondent turns to the legislative history of section 809(c)(1) and section 820. The first clause of the second sentence of section 809(c)(1) (emphasized above) was added to the bill that became the Life Insurance Company Income Tax Act of 1959 in connection with the addition of section 820. The purpose of the enactment of section 820 was to avoid double taxation with respect to modified coinsurance. The Senate Report discussing the provisions of this bill states that dividends to policyholders, paid with respect to the reinsured policy, are to be treated as dividends paid by the reinsurer rather than the initial insurer to the extent of reimbursement by the reinsurer to the initial insurer, while experience refunds paid by the reinsurer to the initial insurer are treated as reductions in premium income of the reinsurer and as other income received by the initial insurer thus avoiding double taxation. S. Rept. No. 291, 86th Cong., 1st Sess. (1959), 1959-2 C.B. 770, 798. Respondent correctly asserts that the first clause of the second sentence of section 809(c)(1) was enacted to prevent the treatment of experience refunds in the same manner as payment of dividends to policyholders by reinsurers. Respondent appears to argue, however, that because section 809(c)(1) was added to the Code contemporaneously with section 809, its application is limited to experience refunds. Because the amounts at issue in

the instant case and in *Beneficial* were not experience refunds, received by the reinsurer and returned to the initial insurer, respondent claims that such amounts are not within the purview of section 809(c)(1).

Return premiums are defined in the regulations as amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Sec. 1.809-4(a)(1)(ii), Income Tax Regs. Respondent's argument apparently equates "return premium" with "experience refund" in construing the return requirement of section 809(c)(1). However, the statute and the regulations specifically exclude experience refunds from the definition of return premiums. See sec. 809(c)(1); sec. 1.809-4(a)(1)(ii), Income Tax Regs. The amounts at issue in the instant case, as in *Beneficial*, were fixed by contract and were not determined by or dependent on the company's experience. Therefore, respondent's assertion that the amount paid to the initial insurer is an experience refund is incorrect. Further, although the reinsurer received only the excess of the required reserves over the initial consideration contained in the contract, respondent agrees that the full amount of the reserves was constructively realized by the reinsurer and is includable in gross income. Respondent, however, refuses to accept that the reinsurer constructively returned an amount (the ceding commission), specified in the contract, to the initial insurer. Under *Beneficial*, petitioner may reduce the gross amount received from Transport by the amount constructively returned to Transport.[4]

Finally, respondent conceded on brief that resolution of the principal issue herein would be determinative of the treatment to be accorded the finders fee of $13,600. Thus, petitioner is allowed a deduction for such amount in the year in which it was paid.

To reflect concessions of the parties and the foregoing, *Decision will be entered under Rule 155.*

[4]We recently reached the same conclusion on similar facts in *Individual Life Assurance Co. v. Commissioner*, T.C. Memo. 1986-201, and *Modern Security Life Insurance Co. v. Commissioner*, T.C. Memo. 1985-629.

IN THE

UNITED STATES COURT OF
APPEALS FOR THE FIFTH CIRCUIT

No. 87-4492

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner-Appellee,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appeal from the Decision of the
United States Tax Court

ON PETITION FOR REHEARING
MAY 25, 1988

Before GARZA, REAVLEY and DAVIS, Circuit Judges.
PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ THOMAS M. REALTY
United States Circuit Judge

UNITED STATES COURT OF
APPEALS FOR THE FIFTH CIRCUIT

No. 87-4492

COLONIAL AMERICAN LIFE INSURANCE COMPANY
Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant

NOTICE OF APPEAL

TO THE HONORABLE COURT OF APPEALS:

Colonial American Life Insurance Company Petitioner-Appellee, hereby gives Notice of Appeal from the Judgment of the Honorable United States Court of Appeals, Fifth Circuit, entered in this cause April 26, 1988 and its Order of Denial of Motion for Rehearing entered May 25, 1988.

Appeal to the U.S. Supreme Court is authorized under 28 USC § 2101.

Respectfully submitted,

/s/ THOMAS G. NASH, JR.

THOMAS G. NASH, JR.
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U.S. COURT OF APPEALS
FILED
ugust 16, 1988
Gilbert F. Ganucheau, *Clerk*

STATUTES[a-1]

Section 162(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 162(a))

SEC. 162. TRADE OR BUSINESS EXPENSES

(a) **In General.** There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including:

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Section 801(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 801(a))

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY

(a) **Life Insurance Company Defined.** For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if:

(1) its life insurance reserves (as defined in subsection (b)), plus

[a-1] The Internal Revenue Code provisions reprinted herein were in effect during the years in controversy, *i.e.*, 1975 and 1976.

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

Section 802(b) of the Internal Revenue Code of 1954 (26 U.S.C. § 802(b))

SEC. 802. TAX IMPOSED

(b) **Life Insurance Company Taxable Income Defined.** For purposes of this part, the term "life insurance company taxable income" means the sum of:

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

Section 806(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 806(a))

SEC. 806. CERTAIN CHANGES IN RESERVES AND ASSETS

(a) **Adjustments to Means for Certain Transfers of Liabilities.** For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the mean of the

assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

Sections 809(b), 809(c)(1) and 809(d)(1), (2), (7) and (12) of the Internal Revenue Code of 1954 (26 U.S.C. §§ 809(b), 809(c), 809(d))

SEC. 809. IN GENERAL

(b) **Gain and Loss from Operations.**

(1) **Gain from Operations Defined.** For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

(2) **Loss from Operations Defined.** For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of:

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

* * *

(c) **Gross Amount.** For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) **Premiums.** The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

* * *

(d) **Deductions.** For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(1) **Death Benefits, Etc.** All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) **Increases in Certain Reserves.** The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

* * *

(7) **Assumption by Another Person of Liabilities Under Insurance, etc., Contracts.** The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

* * *

(12) **Other Deductions.** Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable

income to the extent not allowed as deductions in computing investment yield.

Section 812 of the Internal Revenue Code of 1954 (26 U.S.C. § 812))

SEC. 812. OPERATIONS LOSS DEDUCTION

(a) **Deduction Allowed.** There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of:

(1) the operations loss carryovers to such year, plus

(2) the operations loss carrybacks to such year.

For the purposes of this part, the term "operations loss deduction" means the deduction allowed by this subsection.

Section 818(a) of the Internal Revenue Act of 1954 (26 U.S.C. § 818(a))

SEC. 818. ACCOUNTING PROVISIONS

(a) **Method of Accounting.** All computations entering into the determination of the taxes imposed by this part shall be made:

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

Section 820 of the Internal Revenue Code of 1954 (26 U.S.C. § 820))

SEC. 820. OPTIONAL TREATMENT OF POLICIES REINSURED UNDER MODIFIED COINSURANCE CONTRACTS

(a) **In General.**

(1) **Treatment as Reinsured under Conventional Coinsurance Contract.** Under regulations prescribed by the Secretary or his delegate, an insurance or annuity policy reinsured under a modified coinsurance contract (as defined in subsection (b)) shall be treated, for purposes of this part (other than for purposes of section 801), as if such policy were reinsured under a conventional coinsurance contract.

(2) **Consent of Reinsured and Reinsurer.** Paragraph (1) shall apply to an insurance or annuity policy reinsured under a modified coinsurance contract only if the reinsured and reinsurer consent, in such manner as the Secretary or his delegate shall prescribe by regulations:

(A) to the application of paragraph (1) to all insurance and annuity policies reinsured under such modified coinsurance contract, and

(B) to the application of the rules provided by subsection (c) and the rules prescribed under such subsection.

Such consent, once given, may not be rescinded except with the approval of the Secretary or his delegate.

(b) **Definition of Modified Coinsurance Contract.** For purposes of this section, the term "modified coinsurance contract" means an indemnity reinsurance contract under the terms of which:

(1) a life insurance company (hereinafter referred to as "the reinsurer") agrees to indemnify another life insurance company (hereinafter referred to as "the reinsured") against a risk assumed by the reinsured under the insurance or annuity policy reinsured,

(2) the reinsured retains ownership of the assets in relation to the reserve on the policy reinsured,

(3) all or part of the gross investment income derived from such assets is paid by the reinsured to the reinsurer as a part of the consideration for the reinsurance of such policy, and

(4) the reinsurer is obligated for expenses incurred, and for Federal income taxes imposed, in respect of such gross investment income.

(c) **Special Rules.** Under regulations prescribed by the Secretary or his delegate, in applying subsection (a)(1) with respect to any insurance or annuity policy the following rules shall (to the extent not improper under the terms of the modified coinsurance contract under which such policy is reinsured) be applied in respect of the amount of such policy reinsured:

(1) **Premiums and Gross Investment Income.** The premiums (to the extent allocable to the participation of the reinsurer therein) received for the policy reinsured shall be treated as received by the reinsurer and not by the reinsured. The gross investment income (to the extent allocable to the participation of the reinsurer therein) derived from the assets in relation to the reserve on the policy reinsured shall be treated as gross investment income of the reinsurer and not of the reinsured. The gross investment income so treated shall be considered as derived proportionately from each of the various sources of gross investment income of the reinsured.

(2) **Capital Gains and Losses.** The gains and losses from sales and exchanges of capital assets, and gains and losses considered as gains and losses from sales and exchanges of capital assets, of the reinsured shall (to the extent of the participation therein by the reinsurer under the terms of the modified coinsurance contract) be treated as gains and losses from sales and exchanges of capital assets of the reinsurer and not of the reinsured.

(3) **Reserves and Assets.** The reserve on the policy reinsured shall be treated as a part of the reserves of the reinsurer and not of the reinsured, and the assets in relation to such reserve shall be treated as owned by the reinsurer and not by the reinsured.

(4) **Expenses.** The expenses (to the extent reimbursable by the insurer) incurred with respect to the policy reinsured and with respect to the assets referred to in paragraph (3) shall be treated as incurred by the reinsurer and not by the reinsured.

(5) **Dividends to Policyholders.** The dividends to policyholders paid in respect of the policy reinsured shall be treated as paid by the reinsurer and not by the reinsured. For purposes of the preceding sentence, the amount of dividends to policyholders treated as paid by the reinsurer shall be the amount paid, in respect of the policy reinsured, by the reinsurer to the reinsured as reimbursement for dividends to policyholders paid by the reinsured. This paragraph shall apply also in respect of an insurance or annuity policy reinsured under a conventional coinsurance contract.

(6) **Reimbursement for 1957 Federal Income Tax.** Any amount paid in 1958 or any subsequent year by the reinsurer to the reinsured as reimbursement for Federal income taxes imposed for a taxable year beginning in 1957 or any preceding taxable year shall not be taken into

account by the reinsured as an item under section 809(c) or by the reinsurer as a deduction under section 809(d).

(7) **Rules Prescribed by the Secretary.** Such other rules as may be prescribed by the Secretary or his delegate.

In applying the rules provided by paragraphs (1), (2), (3), (4), (5), and (6) and the rules prescribed under paragraph (7), an item shall be taken into account as income only once under subpart B and only once under subpart C by both the reinsured and the reinsurer, and an item shall be allowed as a deduction only once under subpart B and only once under subpart C to both the reinsured and the reinsurer.

TREASURY REGULATIONS

Treas. Reg. § 1.806-3 (26 C.F.R. § 1.806-3)

§ 1.806-3. CERTAIN CHANGES IN RESERVES AND ASSETS.

(a) **In General.** For purposes of part I, subchapter L, chapter 1 of the Code, section 806(a) provides that if there is a change in life insurance reserves (as defined in section 801(b)), during the taxable year, which is attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such life insurance reserves, then the means of such reserves, and the mean of the assets, shall be appropriately adjusted to reflect the amounts involved in such transfer. For example, the adjustments required under section 806(a) are applicable to transfers in which one life insurance company purchases or acquires a part or all of the business of another life insurance company under an arrangement whereby the purchaser or transferee becomes solely liable on the contracts transferred. This provision shall apply in the case of assumption reinsurance but not in the case of indemnity reinsurance or reinsurance ceded. Thus, no adjustments shall be required under section 806(a) when, in

the ordinary course of business, an indemnity reinsurance contract is entered into with another company (on a yearly renewable term basis, on a coinsurance basis, or otherwise) whereby there is a sharing of risks under one or more individual contracts. It will be necessary for each life insurance company participating in a transfer described in section 806(a) to make the adjustments required by such section. Such adjustments shall be made without regard to whether or not the transferor of the liabilities was the original insurer.

Treas. Reg. §§ 1.809-4(a)(1)(ii) and (iii) (26 C.F.R. §§ 1.809-4(a)(1)(ii) and (iii))

§ 1.809-4. GROSS AMOUNT.

(a) **Items Taken into Account.**

* * *

(1) **Premiums.**

* * *

(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all

or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a)(7)(ii) of § 1.809-5 for the definition of assumption reinsurance.

Treas. Reg. § 1.809-5(a)(7)(i), (ii) and (iii) (26 C.F.R. § 1.809-5(a)(7)(i), (ii) and (iii))

§ 1.809-5. DEDUCTIONS.

(a) **Deductions Allowed.** Section 809(d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively:

* * *

(7) **Assumption by Another Person of Liabilities under Insurance, etc., Contracts.**

(i) The consideration (other than consideration arising out of reinsurance ceded as defined in paragraph (a)(1)(iii) of § 1.809-4) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto) of the taxpayer.

(ii) For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809-4).

(iii) The provisions of section 809(d)(7) and this subparagraph may be illustrated by the following example:

Example. During the taxable year 1958, T, a life insurance company, transferred a block of

insurance policies and made a payment of $50,000 to R, a life insurance company, under an arrangement whereby R became solely liable to the policyholders on the policies transferred by T. Under the provisions of section 809(d)(7) of this subparagraph, T is allowed a deduction of $50,000 for the taxable year 1958. For the treatment by R of this $50,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809-4. See section 806(a) and § 1.806-3 for the adjustments in reserves and assets to be made by T and R as a result of this transaction.

Treas. Reg §§ 1.817-4(d)(1) and (2) (26 C.F.R. §§ 1.817-4(d)(1), (2))

§ 1.817-4. SPECIAL RULES.

(d) **Certain Other Reinsurance Transactions.**

(1) For any taxable year beginning after December 31, 1958, the reinsurance of all or a part of the insurance contracts of a particular type by a life insurance company, in either a single transaction, or in a series of related transactions, occurring in any such taxable year, whereby the reinsuring company or companies assume all liabilities under such contracts, shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of sections 806(a) and 809 and the regulations thereunder. However, if in connection with a transaction described in the preceding sentence the reinsured or reinsurer transfers an asset which is a capital asset within the meaning of section 1221 (as modified by section 817(a)(2)), such transfer shall be treated as the sale or exchange of a capital asset by the transferor.

* * *

(2)(i)(ii) In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809-5) transaction, a reinsurer shall in any taxable year beginning after December 31, 1957:

(A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and

(B) Treat any such amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

(iii) For purposes of paragraph (d)(2)(ii) of this section where the reinsured transfers to the reinsurer in connection with the assumption reinsurance transaction a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer shall be treated as:

(A) Having received from the reinsured consideration in an amount equal to the net amount of the increase in the reinsurer's reserves resulting from the transaction, and

(B) Having paid the reinsured an amount for the purchase of the contracts equal to the excess of the amount of such increase in the

reinsurer's reserves over the net amount received from the reinsured.

(iv) For purposes of this subparagraph, the term "reasonably estimated life" means the period during which the contract reinsured remains in force. Such period shall be based on the facts in each case (such as age, health, and sex of the insured, type of contract reinsured, etc.) and the assuming company's experience (such as mortality, lapse rate, etc.) with similar risks.

In the
United States Court of Appeals
For the Seventh Circuit

No. 87-2129

MERIT LIFE INSURANCE COMPANY,

Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeal from the Decision of the
United States Tax Court.
No. 13441-78—Julian I. Jacobs, *Judge.*

ARGUED JANUARY 21, 1988—DECIDED AUGUST 11, 1988

Before CUMMINGS, WOOD, JR., *Circuit Judges*, and WILL, *Senior District Judge.**

WILL, *Senior District Judge.* This appeal involves the tax consequences of a general practice in the insurance industry called reinsurance. For any number of reasons, insurance companies transfer all or part of the risk of a block of policies, under which they are the original insurer, to another insurance company, the reinsurer, in exchange for, among other things, a commission. The original in-

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* The Honorable Hubert L. Will, Senior Judge of the United States District Court for the Northern District of Illinois, Eastern Division, is sitting by designation.

surer is known as the reinsured or ceding company and commissions paid by the reinsurer (or retained by the reinsured) are called ceding commissions. There are two general types of reinsurance: indemnity and assumption. At issue is the tax treatment for ceding commissions in indemnity reinsurance transactions.

In indemnity reinsurance, the ceding company does not relinquish any of its contractual interest in the policies it issued and remains directly liable to the policy holders. No relationship, contractual or otherwise, exists between the reinsurer and the policy holders. The ceding company pays the reinsurer a percentage of the premiums it received, upon issuance of the policies, proportional to the risk assumed by the reinsurer, which may be part or all of the total risk. The ceding company continues to pay claims and expenses and collect premiums, and pays the reinsurer a percentage of the future premiums again based on the risk transferred. In exchange, the reinsuring company reimburses (indemnifies) the ceding company for its share of the claims and expenses attributable to the risk reinsured and pays (or the ceding company retains) a ceding commission.

State laws and regulations require that an insurance company maintain a reserve, in cash or other assets, reflected as a liability for accounting purposes, representing the excess of the present value of future benefits payable under the life insurance policy over the present value of future net premiums received. The amount of the reserve changes over the life of a policy and the reserve may not be used for other corporate purposes, such as distributing dividends to shareholders. However, the reserve may be invested to produce interest income. Indemnity reinsurance reduces the reserve required of the ceding company and increases the reserve required of the reinsurer, based on the proportion of the risk transferred to the reinsurer.[1]

[1] The indemnity reinsurance described above is specifically known as conventional indemnity reinsurance. There is another type of

(Footnote continued on following page)

In contrast, assumption reinsurance involves the purchase of a block of insurance policies by the reinsurer from the original insurer at which point the reinsurer assumes *all* of the original insurer's risks and obligations and becomes directly liable to the policy holders. The original insurer is then relieved of all liability under the policies and the policy holders are informed that henceforth they are insured by the reinsuring company and all future premiums are to be paid and claims made to the reinsurer. The reinsurer pays all future claims, commissions, expenses and taxes. In addition, the reinsurer assumes the entire reserve liability, thereby reducing the ceding company's reserve liability. The purchase price is normally greater than but includes a commission to the selling company. The reinsurer simply purchases the policies and steps into the shoes of the ceding or selling company.

This case involves indemnity reinsurance. Merit Life Insurance Company ("Merit"), petitioner-appellee, an Indiana corporation, reinsured (agreed to indemnify) specified percentages, but not 100%, of five blocks of insurance policies, four of which were originally insured by American General Life Insurance Company of Delaware and one by American General Life Insurance Company of New York (both original insurers are hereinafter referred to as "American General"). American General paid "reinsurance premiums" to Merit, in an amount equal to the reserves Merit was

[1] *continued*
indemnity reinsurance called modified coinsurance in which the ceding company continues to hold the entire reserve, but pays the reinsurer any investment income attributable to the assets supporting the reserve. The two companies, however, may consent, pursuant to 26 U.S.C. § 820(a), to have the tax consequences for each company be the same as if the reinsurer was maintaining the reserve in the case of conventional indemnity reinsurance. In effect, the reinsured maintains the reserve as a custodian on behalf of the reinsurer.

required to carry on the policies less ceding commissions payable by Merit to American General.[2]

In addition, under the terms of the contracts, American General agreed to transfer a specified percentage of the gross premiums thereafter received on the reinsured policies and Merit agreed to pay American General for its share of commissions, premium taxes and other expenses incurred by American General. Finally, each contract provided that American General could recapture the reinsured policies on specific dates.

During the tax years in question, 1973-75, Merit claimed a tax loss, under 26 U.S.C. § 809(b) (section 809(b) of "the Code"),[3] on each of the indemnity reinsurance contracts because the reserves required and expenses incurred with respect to each contract exceeded the reinsurance premiums Merit received from American General. Specifically, Merit recognized as gross income the consideration (reinsurance premiums) deemed received from American

[2] Two of the five reinsurance transactions at issue here are modified coinsurance transactions but Merit and American General employed section 820(a) for tax purposes. Consequently, the same tax result applies as if all five transactions were conventional indemnity reinsurance transactions, and, for convenience, we will refer to all five as indemnity reinsurance transactions.

One of the three conventional coinsurance agreements specified that American General agreed to pay Merit a reinsurance premium equal to the reserve liability on the block of policies and Merit in turn agreed to pay a ceding commission which American General offset against the reinsurance premium. The other two conventional coinsurance agreements only provide for the payment of a reinsurance premium. It is understood, however, that the reinsurance premium with respect to these two agreements represents the reserve liability less a ceding commission. Thus, all five transactions are treated as conventional indemnity reinsurance transactions which result in an actual money transfer from American General to Merit of a reinsurance premium less a ceding commission.

[3] The years in issue are governed by the Internal Revenue Code of 1954 and the Life Insurance Company Income Tax Act of 1959, 26 U.S.C. §§ 801-820.

General for assuming reserve liabilities, pursuant to section 809(c)(1), and deducted the same amount as the reserve liability, pursuant to section 809(d)(2). Merit also deducted the ceding commissions paid to (or retained by) American General from its gross premiums (gross income), pursuant to section 809(c)(1).[4] Since these amounts exceeded the gross premiums, Merit reported a loss for the transactions which it used to offset gains from other operations during those years.

The Commissioner of Internal Revenue ("Commissioner"), respondent-appellant, found deficiencies in Merit's declared federal income taxes based on Merit's *current* deduction of all the ceding commissions in the tax years in which it issued the indemnity reinsurance.[5] The Commissioner determined that the ceding commissions must be *amortized* over the anticipated lives of the reinsurance contracts (between 57 and 64 months) because, according to the Commissioner, the reinsurance contracts are intangible assets with useful lives or more than one year.[6]

[4] Section 809 provides the following in relevant part:

(c) (1) *Premiums.*—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto), *less return premiums, and premiums and other consideration arising out of reinsurance ceded.* . . .

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(2) *Increase in certain reserves.*—The net increase in reserves which is required . . . .

26 U.S.C. § 809 (emphasis added).

[5] The Commissioner also found a deficiency in Merit's 1972 tax return. The issues with respect to 1972, however, were settled and are not before us.

[6] Under the contracts between Merit and American General, American General had the right to reacquire the insurance business on a scheduled basis, ranging from 57 to 64 months after the issuance of the reinsurance.

Merit petitioned the United States Tax Court for a redetermination of the deficiencies. The case was submitted to the Tax Court without a trial and resolved based on the parties' stipulated facts and exhibits. The Tax Court, relying on its earlier opinion in *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627 (1982), reversed the Commissioner and held that in indemnity reinsurance arrangements the ceding commissions are deductible in full in the year in which the indemnity reinsurance is issued. *Merit Life Insurance Company v. Commissioner of Internal Revenue*, 52 T.C.M. (CCH) 638 (1987).

The Tax Court reaffirmed its view that an indemnity reinsurance transaction is not the purchase of an asset, but rather the sale of insurance by the reinsuring company to the ceding company. Accordingly, the Tax Court, as it had in *Beneficial Life*, viewed the ceding commissions paid by the reinsuring company (or retained by the reinsured) as analogous to currently deductible underwriting expenses such as agents' commissions paid by an original insurer on the issuance of a policy and reversed the Commissioner's disallowance of their deduction. The Commissioner appeals the Tax Court's ruling. We affirm.

Standard Of Review

As noted above, the Tax Court's decision was based on stipulated facts and exhibits. The court's holding that the ceding commissions in an indemnity reinsurance transaction are immediately deductible, based on uncontested facts, is a conclusion of law. Accordingly, we review the record *de novo*. *United Fire Insurance Company v. Commissioner of Internal Revenue*, 768 F.2d 164, 167 (7th Cir. 1985). *See also Vukasovich, Inc. v. Commissioner of Internal Revenue*, 790 F.2d 1409, 1413 (9th Cir. 1986) ("A general rule of special deference to the Tax Court is inappropriate although its judgments in its field of expertise are always accorded a presumption that they correctly apply the law."); 26 U.S.C. § 7482(a) (1982).

Analysis

The Commissioner asked the Tax Court and now asks us to reconsider *Beneficial Life*. The Tax Court in *Beneficial Life* distinguished indemnity reinsurance from assumption reinsurance by deeming the former to be the "issuance of insurance," for which ceding commissions are immediately deductible, and the latter to be the "acquisition of an asset," for which ceding commissions must be amortized. 79 T.C. at 648. The Commissioner acknowledges that the distinction between assumption and indemnity reinsurance is significant to the policy holders and the ceding company but argues that it does not alter the reinsurer's position and should not create distinct tax consequences. According to the Commissioner, in both cases the reinsurer pays consideration (ceding commissions) for the right to receive future profits (reinsurance premiums) and, following the tax principle of matching expenses incurred (year by year) with income generated, *see Commissioner v. Idaho Power Co.*, 418 U.S. 1, 12 (1974), the consideration must be amortized.

Merit argues that indemnity and assumption reinsurance are different and must be treated differently for tax purposes. It points out that the Code specifically treats both differently and the Tax Court recognized this in *Beneficial Life*. Although this distinction may not achieve a direct matching of income and expenses for tax purposes, the Code and treasury regulations provide for it. The same is true, it should be noted, as to the deduction of all commissions paid on the sale of insurance.

The court in *Beneficial Life* specifically rejected the Commissioner's argument that ceding commissions in indemnity reinsurance transactions must be amortized:

> Respondent [Commissioner] cites to us numerous cases which required capitalization and amortization of acquisition expenses. However, such cases apply when an asset is acquired, not when insurance is sold. Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit,

such is also true when an insurance company issues a single policy to an individual. Yet, the expenses related to that policy are currently deductible. While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. *In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet the Code treats one as the issuance of insurance and one as acquisition of an asset. That makes all the difference.*

79 T.C. at 647-48 (emphasis added).

The Tax Court's reasoning in *Beneficial Life* is supported by the explicit language in section 809(c)(1) and the applicable treasury regulations. Section 809(c)(1) provides that an insurance company's gross income equals "the gross amount of premiums and other consideration . . . less return premiums, and premiums and other consideration arising out of reinsurance ceded." *See* note 4 *supra*. Under section 809(c)(1), "reinsurance ceded" includes commissions from indemnity reinsurance transactions but not from assumption reinsurance transactions.

> (iii) For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. *Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions.* See paragraph (a)(7)(ii) or section 1.809-5 for the definition of assumption reinsurance.

Treas. Reg. § 1.809-4(a)(1)(iii) (emphasis added).

> (ii) For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. *Such term does not include indemnity reinsurance* or reinsurance ceded (as defined in paragraph (a)(1)(iii) or section 1.809-4).

Treas. Reg. § 1.809-5(a)(7)(ii) (emphasis added). *See also* S. Rep. No. 291, 86th Cong., 1st Sess., at 54 (1959), *reprinted in* 1959 U.S. Code Cong. & Ad. News 1575; 1959-2 C.B. 770, 809. In contrast, ceding commissions paid in an assumption reinsurance transaction must be amortized:

> (2)(ii) In connection with an assumption reinsurance . . . transaction, a reinsurer shall . . .
>
> (B) Treat any amount paid to the reinsured for the purchase of such contracts, . . . , as a deferred expense that may be amortized over the reasonably estimated life . . . of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

Treas. Reg. § 1.817-4(d)(2)(ii)(B).

The Commissioner contends that "reinsurance ceded" under section 809(c)(1) refers only to the reinsured or ceding company and not to the reinsurer. There is no provision, however, in section 809 of the applicable treasury regulations which even remotely suggests the Commissioner's interpretation or distinction. In addition, the term "return premiums" is defined in the regulations as follows:

> (ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. *Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums* . . . .

Treas. Reg. § 1.809-4(a)(1)(ii) (emphasis added). Moreover, section 809(c)(1) provides for a *deduction* of ceding commissions from gross premiums earned. A ceding company *adds* ceding commissions to gross income. For the ceding company, ceding commissions represent income, not expenses (which are deducted). On the other hand, for the reinsuring company, indemnity reinsurance ceding commissions represent a current expenses which would normally be deductible as are commissions paid to a salesperson upon the sale of a policy or when premiums are received in subsequent years. *Beneficial Life*, 79 T.C. at 646.

The Court of Appeals for the Fifth Circuit, in an opinion decided after the oral argument in our case, adopted the Commissioner's position that ceding commissions in indemnity reinsurance contracts must be amortized over the anticipated life of the reinsurance contract.[7] *Colonial American Life Insurance Company v. Commissioner*, 843 F.2d 201 (5th Cir. 1988). The Fifth Circuit held that "without a clear difference in the statute [Code] for treatment of assumption reinsurance contracts and indemnity reinsurance contracts, we must apply [the] 'general' tax rule" which matches income and expenses such that expenses incurred to acquire a capital asset (in general, one with a useful life greater than one year) must be amortized over the expected life of the asset. 843 F.2d at 204. The Fifth Circuit embraced the Eighth Circuit's reasoning in *Modern American Life Insurance Co. v. Commissioner*, 818 F.2d 1386 (8th Cir. 1987) and *Prairie States Life Insurance Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987).

The Court of Appeals for the Eighth Circuit in *Modern American* held that ceding commissions in modified coinsurance transactions, where no section 820 election is made, *see* note 1 *supra*, reflect acquisition costs of capital assets which must be amortized. The *Modern American* court, however, distinguished the contract at issue there from the modified coinsurance transactions at issue in *Beneficial Life*, in which section 820 elections were made. 818 F.2d at 1389. ("The facts of *Beneficial Life* are therefore not before us, and thus we express no opinion as to the correctness of the result in that case.").[8]

[7] The contracts at issue in *Colonial American* involved both conventional and modified indemnity reinsurance transactions but, as in our case, the parties consented to the optional tax treatment under section 820(a) with respect to their modified indemnity reinsurance transactions and, thus, the reinsurance transactions presented there are the same as those in our case.

Merit argues that this distinction renders *Modern American* irrelevant to our case. In response, the Commissioner argues that, notwithstanding the Eighth Circuit's statement to the contrary, a section 820 election has no bearing on the tax treatment of ceding commissions. Because a section 820 election was made in our case, we need not express an opinion on the distinction, if any, between modified indemnity reinsurance transactions where a section 820 election is not made and a modified indemnity reinsurance transaction where a section 820 election is made, with respect to the tax treatment of ceding commissions.

The Eighth Circuit in *Prairie States* was presented with conventional indemnity reinsurance contracts and the court found no distinction between modified indemnity reinsurance where no section 820 election is made (the facts in *Modern American*) and conventional reinsurance with respect to the tax treatment of ceding commissions. More importantly, the court equated conventional reinsurance with assumption reinsurance and reasoned that both involve the acquisition of a capital asset and because ceding commissions must be amortized in assumption (purchase) reinsurance transactions, ceding commissions must also be amortized in indemnity (non-purchase) reinsurance transactions.

[8] *Beneficial Life* also involved conventional indemnity reinsurance and assumption reinsurance transactions.

It makes no difference that in this transaction, unlike the one in *Modern American*, there is income from which taxpayer could in theory deduct the commission as a 'return premium.' The real issue, and the one decided in *Modern American* with respect to modified coinsurance, is whether Section 809(c)(1) should be read to permit taxpayer to treat as an immediate reduction of income during the taxable year the cost of acquiring in a conventional coinsurance arrangement an intangible asset 'with an income-producing life extending substantially beyond the taxable year.' [*Modern American*, 830 F.2d] at 114. We hold that Section 809(c)(1) should not be so read.

* * * * *

[W]e do not believe that Congress intended to treat a ceding commission of the kind here at issue as a currently deductible underwriting expense analogous to an agent's commission paid by a direct insurer. . . . [T]he commission represents a one-time payment for the acquisition of an economic interest in a block of previously issued policies.

828 F.2d at 1233-34.

The Commissioner and the Courts of Appeals for the Fifth and Eighth Circuits fail to recognize the inherent distinctions between assumption and indemnity reinsurance transactions and the legal distinctions provided by the Code and the treasury regulations cited above. From the reinsuring company's perspective, indemnity reinsurance is not an acquisition of an intangible asset with a useful life of more than one year. By its nature, an indemnity reinsurance transaction is, from the perspective of the reinsurer, simply an indemnity or co-insurance arrangement, in substance, the sale of an insurance policy by the reinsurer to the ceding company. Economically, it is substantially the same as the sale of any other policy. In contrast, assumption reinsurance is by its nature the purchase of already issued insurance policies and the elimination of any participation or interest of the selling or ceding company.

The improper characterization of indemnity reinsurance transactions by the Fifth and Eighth Circuits and the Commissioner contributed to their misunderstanding and misinterpretation of the Code and application of the treasury regulations. In addition to embracing the Eighth Circuit's reasoning in *Modern American* and *Prairie States*, the Fifth Circuit in *Colonial American* also adopted the same rationale for indemnity reinsurance transactions as it had previously for assumption reinsurance transactions. 843 F.2d at 205, *citing Southwestern Life Ins. Co. v. United States*, 560 F.2d 627, 640-41 (5th Cir. 1977), *cert. denied*, 435 U.S. 995 (1978).

Interestingly, the Fifth Circuit in *Southwestern Life* held that "equat[ing] the current deductibility of commissions paid in the life insurance industry to agents who put new policies on the books of the company with the payment of $9,800,000 for the acquisition of some 100,000 outstanding policies is not an apt comparison." 560 F.2d at 641. That reasoning is, of course, consistent with the distinctions made by the Code and recognized and applied in *Beneficial Life* to assumption reinsurance, the type of reinsurance before the court in *Southwestern Life*. It does not follow, however, that the cost of acquiring already existing insurance policies, as in the case of assumption reinsurance, should be equated with the expenses incurred in what amounts to the sale of new insurance policies, as in the case of indemnity reinsurance. Moreover, the Code, treasury regulations and legislative history recognize that indemnity reinsurance and assumption reinsurance are to be treated differently with respect to the tax treatment of ceding commissions paid.

The Eighth Circuit also equated indemnity reinsurance with assumption reinsurance, even after recognizing that the Code and treasury regulations distinguish between the two transactions. Indeed, after noting that assumption reinsurance is "explicitly governed by Treas. Reg. § 1.817-4(d)," the court in *Prairie States* claimed that section 1.817-4(d)(2)(iii) "specifically covers transactions *similar* to the one in this case, 'where the reinsured transfers

to the reinsurer in connection with [an] *assumption reinsurance transaction* a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction." 828 F.2d at 1230 (emphasis added). While there is some similarity between assumption and indemnity reinsurance, the differences substantially outweigh the similarities and to equate the tax treatment of the two transactions based on their similarities is improper, especially in light of the fact that section 1.817-4(d)(2)(iii) applies specifically only to assumption reinsurance.

The court in *Prairie States* later acknowledged that section 1.817-4(d)(2)(ii) "by its terms applies only to assumption reinsurance transactions. Moreover, the definition of assumption reinsurance, contained in Treas. Reg. § 1.809-5(a)(7)(ii), specifically excludes indemnity reinsurance." 828 F.2d at 1232. Notwithstanding, the court found that the "principles" behind the tax provisions for assumption reinsurance (illustrated in the treasury regulations), should also control the tax treatment of ceding commissions in indemnity reinsurance transactions. *Id.* We disagree.

The current deduction of agents' commissions by *direct insurers* is provided for in the Code. In addition, the legislative history surrounding the Deficit Reduction Act of 1984 ("DEFRA"), although not controlling, recognized and strengthened this provision.

> The change [DEFRA] from present law [1959 Act] was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).

H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1428 (1984), *reprinted in* 1984 U.S. Code Cong. & Admin. News 697, 1073; Senate Comm. On Finance, S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess., at 555 (1984). Because substantively indemnity reinsurance is the sale of insurance by the reinsurer to the ceding company, it follows that, in addition to the explicit provisions of the Code and treasury regulations, the principles governing the sale of insurance, in the case of direct insurers, also apply to indemnity reinsurers.

Merit argues that reinsurance is just what it sounds like: insured insurance. Whether or not an insurance company sells insurance to an individual or to another insurance company, each involves the issuance of new policies and the transfer of a risk and, under the Code, the commission expenses incurred in either transaction, whether paid to insurance agents in the case of individual policies or to ceding companies in the case of reinsurance, are deductible in the year of their payment. The Commissioner does not dispute that commissions paid to agents in connection with the sale of individual insurance policies by an original insurer are currently deductible in the year of the transaction.

The Court of Appeals for the Ninth Circuit recently distinguished assumption reinsurance from indemnity reinsurance with respect to the tax treatment of ceding commissions. *Oxford Life Insurance Company v. United States*, 790 F.2d 1370 (9th Cir. 1986). Although that case involved assumption reinsurance, the court emphasized its holding by making the following comparison between both reinsurance transactions:

> Assumption reinsurance transactions receive different treatment in the Tax Code from that accorded indemnity reinsurance transactions because of the transfer of assets. An assumption reinsurance transaction is treated as a sale of policies; an indemnity reinsurance transaction is the purchase of insurance protection [by] the reinsured. *Beneficial Life*, 79 T.C. at 645-46.
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> The exception created in the statute for 'reinsurance ceded' specifically refers to indemnity reinsurance. Treas. Reg. § 1.809-4(a)(1)(iii); S. Rep. No. 291,

> 86th Cong., 1st Sess. at 54 (1959-2 Cum.Bull. 809). Thus, indemnity reinsurers may subtract from income any consideration returned to the ceding company with respect to the reinsurance ceded. *Beneficial Life*, 79 T.C. at 646. . . . While the [treasury] regulation notes that the definition of return premiums is specifically broadened in the case of indemnity reinsurers, *see* Treas. Reg. §§ 1.809-4(a)(1)(ii) and (iii), assumption reinsurers, as noted earlier, receive different treatment in the tax code. *See Beneficial Life*, 79 T.C. at 646-47.

790 F.2d at 1376. In addition to those provisions of the Code cited above, other provisions draw distinctions between indemnity and assumption reinsurance. *See* 26 U.S.C. §§ 806,[9] and 809(d)(7).[10]

The Court of Appeals for the Second Circuit has affirmed the Tax Court's ruling concerning a life insurance company's deductions under section 809(d)(5) for increases in reserves for "certain nonparticipating contracts." *Cologne Life Reinsurance Co. v. Commissioner*, 80 T.C. 859 (1983), *aff'd by summary order*, 732 F.2d 141 (2nd Cir. 1984) (un-

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[9] 26 U.S.C. § 806(a) provides in relevant part:

> . . . if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, . . . , the means of such reserves, and the means of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

[10] Section 809(d)(7) provides the following in relevant part:

> (d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:
>
> (7) *Assumption By Another Person Of Liabilities Under Insurance, Etc., Contracts.*—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

published opinion). Although dicta, the Tax Court in *Cologne* began its discussion by distinguishing between assumption and indemnity reinsurance transactions. 80 T.C. at 862 ("[T]he issuance of indemnity life reinsurance is treated generally as the issuance of life insurance."), *citing Beneficial Life*, 79 T.C. at 647-48.

Congressional history supports the similar tax treatment for indemnity reinsurance and directly-written insurance contracts, with respect to the deduction of expenses (and consequently a dissimilar tax treatment than for assumption reinsurance):

> Modified coinsurance is a form of indemnity reinsurance (as contrasted to assumption reinsurance) to indemnify an insurer against a risk it has assumed. . . . Three forms of this indemnity reinsurance have been developed. The first of these, called coinsurance, calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that *the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly*. Any expenses incurred by the initial insurer with respect to the policy are reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems.

S. Rep. No. 291, 86th Cong., 1st Sess., at 38-39 (1959), *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1959-2 C.B. 770, 797-798 (emphasis added). Had Merit acted as the original insurer with respect to the policies in these contracts, rather than as a reinsurer, it would have incurred an underwriting loss because the reserves required and expenses incurred generally exceeded the premiums received during the year the insurance was issued. Brief of *Amici Curiae* at 5.

In addition, legislative descriptions of recent revisions to the Code, although not controlling here, are indicative of the distinctions between indemnity and assumption reinsurance.

> Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, at 633 (Dec. 31, 1984). This explanation is verbatim from a Technical Advice Memorandum prepared by the Commissioner just prior to the Commissioner's appeal in this case. Tech. Adv. Mem. 87-42-004 (June 30, 1987). *See* Brief of *Amici Curiae* at n. 13.

Finally, the Commissioner claims that generally accepted accounting principles ("GAAP") hold that ceding commissions in indemnity reinsurance transactions should be amortized as an acquisition expense and, thus, tax accounting should employ the same treatment. Respondent-Appellant's Brief at n. 22.[11] The difficulty with that contention is that GAAP would only control the deduction of ceding commissions if the Commissioner's basic assumption were correct: that *indemnity reinsurance* transactions represent the acquisition of a capital asset. That assumption is, however, erroneous.

In addition, the Supreme Court has expressed a preference for the accounting rules and procedures of the National Association of Insurance Companies ("NAIC"). The Court has interpreted 26 U.S.C. § 818(a) as providing that the tax liability for insurance companies is to be com-

[11] Treas. Reg. § 1.461-1(a)(2) provides:

> (2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred.

puted consistent with the NAIC's rules except where "accrual accounting dictate[s] a contrary result, . . ." *Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148, 159 (1977).[12] Because generally accepted accounting principles (accrual accounting) do not control the tax treatment for ceding commissions in indemnity reinsurance transactions, we must consider the NAIC's rules. Both parties agree that Merit's current deduction of ceding commissions followed the accounting rules for life insurance companies established by the NAIC.

Allowing insurance companies to immediately deduct ceding commissions for indemnity reinsurance but not for assumption reinsurance reflects the inherent differences between the two transactions and the complexities of the insurance industry.

> We realize that it may seem strange at first for the assumption reinsurance transaction and the indemnity reinsurance transactions at issue herein to have such different tax consequences when they are, at heart, so similar. An understanding of that difference must flow from the understanding of the complex and somewhat unique rules applicable to the insurance industry. . . .
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> . . . [R]eserves are deduction when set up and when added to; premiums are income as received; . . . and,

[12] 26 U.S.C. § 818(a) provides the following:

> (a) Method of Accounting.—All computations entering into the determination of the taxes imposed by this part shall be made—
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

> decreases in reserves give rise to income. Additionally, an insurance company may deduct currently expenses such as commissions, taxes, and underwriting expenses. It is within that framework that indemnity reinsurance, as the reinsurer's sale of insurance, falls. In essence, the allowance paid the ceding company is analogous to currently deductible underwriting expenses.

Beneficial Life, 79 T.C. at 646-47 (citation and footnote omitted).

If American General had withheld or deducted the ceding commissions from the reinsurance premiums prior to paying them to Merit, without specifically referring to "ceding commissions" in the agreements, the tax consequences would have been exactly the same as the Tax Court has held: Merit's taxable income would have been reduced by the ceding commissions in the year in which the reinsurance was issued. Merit's gross income would automatically have been reduced. Gross income reflects actual consideration received and this would have been reduced by the withheld amounts, thus producing the same net loss. Merit would not have had to subtract ceding commissions from the reinsurance premiums it received. In fact, it appears that two of the five agreements were structured in this manner. *See* note 2 *supra*.

Alternatively, Merit claims that ceding commissions are deductible under sections 162 and 809(d)(12) as one of many "other deductions" or ordinary business expenses. The Tax Court in *Beneficial Life* noted that ceding commissions in indemnity reinsurance transactions are analogous to currently deductible underwriting expenses of a direct insurer. 79 T.C. at 647. Those deductions are made pursuant to section 809(d)(12).[13] Because we hold

[13] Section 809(d)(12) provides the following in relevant part:

> (d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(Footnote continued on following page)

that ceding commissions are deductible from gross premiums under section 809(c)(1), we need not address Merit's alternative argument, although we agree with the Tax Court's analogy.

Conclusion

In sum, we conclude that the Code, treasury regulations and legislative history support the petitioner's position and the Tax Court's holding that ceding commissions paid by a reinsuring company or retained by the reinsured company, in an indemnity reinsurance transaction or in a modified indemnity reinsurance transaction in which both insurance companies have consented to treat the transaction as a conventional indemnity reinsurance transaction pursuant to 26 U.S.C. § 820(a), are immediately deductible by the reinsurer in the year in which the reinsurance is issued.

The opinion of the Tax Court is

AFFIRMED.

A true Copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

[13] *continued*

> (12) *Other Deductions.*—. . . , all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

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